ECON 165, Review Section # 7

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Plan for Today

- Cole Kehoe

- Practice

Model Comparisons

Eaton Gersovitz:

Cole Kehoe:

Model Comparisons

Eaton Gersovitz:

- Government defaults on B_0 at the end of period $t = 1$ and on B_1 at the end of period $t = 2$
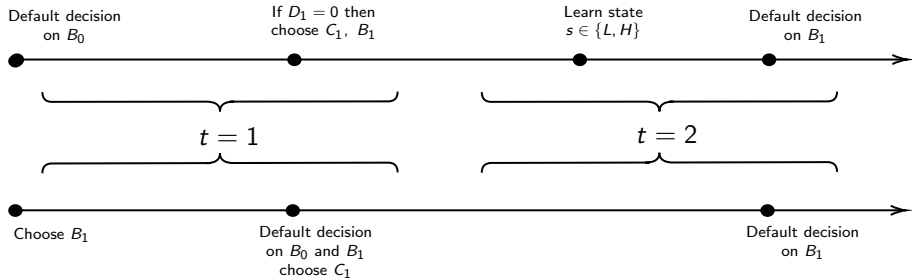- Y_1 and $Y_2(s)$ are the tax revenues.

Cole Kehoe:

- Government defaults on B_0 and B_1 at the period $t = 1$ and again on B_1 at the end of period $t = 2$.
- $Y_1 = Y_2(s) = Y$.

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Cole-Kehoe: Solution pg. 1

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$$q(B_1) = \begin{cases} \frac{1}{1+r^*} & \text{if } B_1 \leq \tau Y \\ 0 & \text{otherwise} \end{cases}$$

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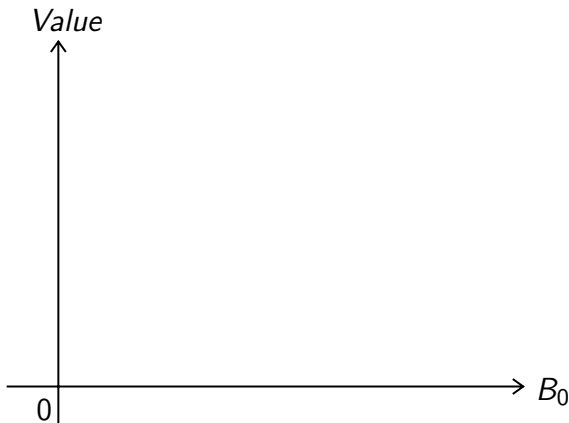$$q(B_1) = \begin{cases} \frac{1}{1+r^*} & \text{if } B_1 \leq \tau Y \\ 0 & \text{otherwise} \end{cases}$$

- If lenders think the govt. will default at $t = 1$, then what is $q_1(B_1)$?

$$q(B_1) = 0$$

Cole-Kehoe: Solution pg. 2

- V^{def}: utility when defaults at $t = 1$
- $V^{\text{no def - opt}}$: utility when no default at $t = 1$ and access to B_1
- $V^{\text{no def - pes}}$: utility when no default at $t = 1$ and no access to B_1

Value

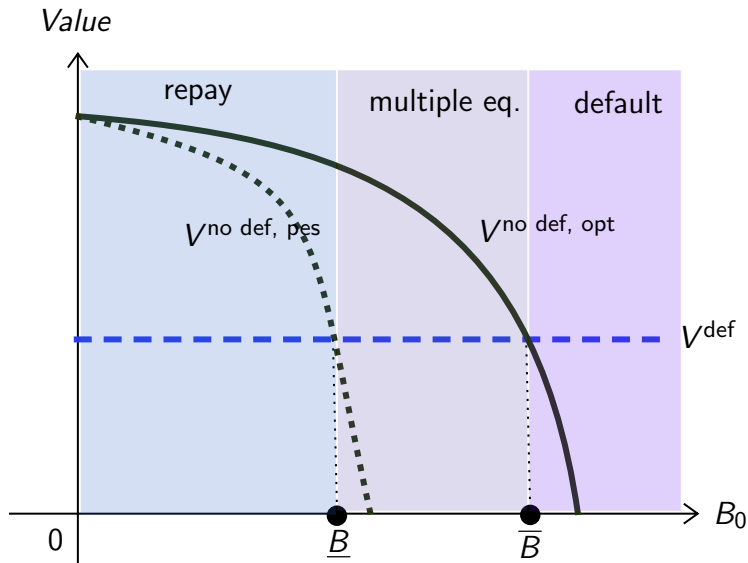
0 $\rightarrow B_0$

Cole-Kehoe: Solution pg. 2

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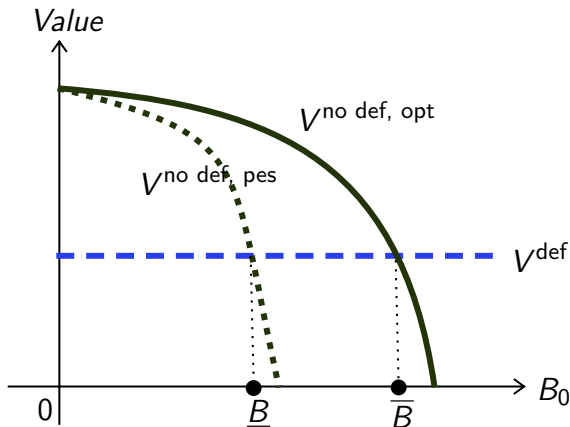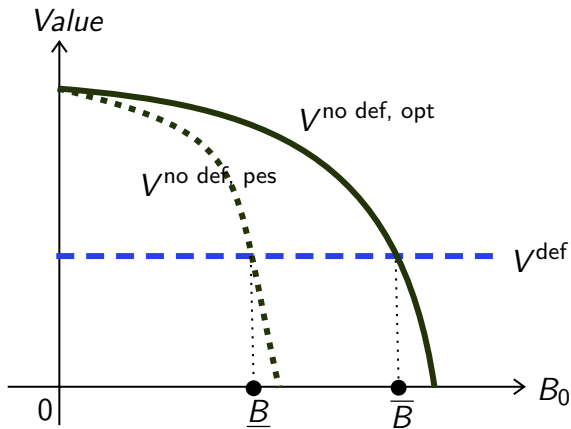
Cole-Kehoe: Equilibria

Cole-Kehoe: Multiple Equilibria, pg. 1

- if $B_0 < \underline{B}$: no crisis zone

- if $B_0 > \overline{B}$: default zone

- if $B_0 \in \left[\underline{B}, \overline{B}\right]$: crisis zone

- What determines which equilibrium prevails in the middle region?

$\rightarrow$ the lender's beliefs will determine the equilibrium:

  - if lenders are pessimistic about repayment then govt. defaults (because it has no access to financial markets)

  - if lenders are optimistic about repayment then govt. repays (because it has access to financial markets)
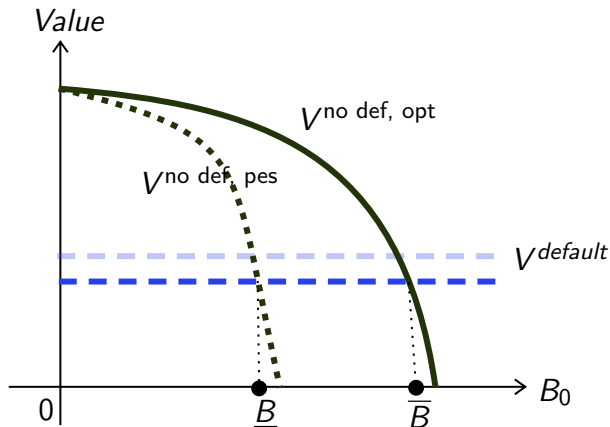
Cole-Kehoe: Comparative Statics

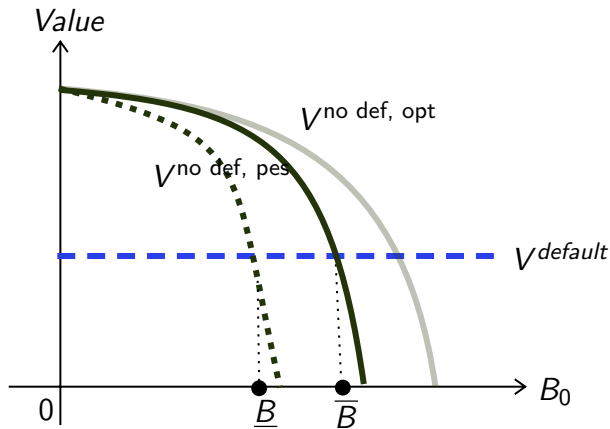- What if τ increases? What if r^* increases?

Cole-Kehoe: Comparative Statics

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Cole-Kehoe: Comparative Statics

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Practice: Lifeline

A country has $B_0 = 0$ and utility $\ln(G_1) + \beta \ln(G_2)$. Endowments are Y_1 and $Y_2(s)$ with prob. π_s for $s \in \{L, H\}$. If the government defaults it suffers a revenue cost τ but the IMF intervenes and gives it a lifeline Y_{free}. What is the pricing schedule for $q(B_1)$ and how does it depend on Y_{free}?

Speed Round

- Removing exclusion from financial markets increases the pricing schedule $q(B)$.

- Conditional on all else, according to the Eaton-Gersovitz model, a history of defaults will affect your chances of default tomorrow.

- Defaults are correlated across countries.